

IN THE MATTER OF: : CIVIL ACTION
ETHEL MARIE MINTZE, :
Appellee :
: :
: :
: NO. 03-2113

- 1 -

refinanced her current mortgage and consolidated her credit card debt.

The appellee had been referred to the appellants in the fall of 2000 for the financing of a heater installation for her home. The heater installation would cost \$3,800. The appellee contends that as a condition of financing the heater, the appellants required that she borrow \$44,716.34. The loan transaction note was dated October 20, 2000 and contained an arbitration clause. The monthly payments, to be made over 15 years, would be \$551.13, and the annual percentage rate was set at 13.44%. The appellee alleges the loan principal included \$2,800 in settlement charges, as well as \$2,000 for life insurance policies.

The appellee did not make all of the payments to the appellant. She attempted to rescind the transaction pursuant to the Truth in Lending Act, 15 U.S.C. § 1602 ("TILA"), and she later filed the action underlying this case in Bankruptcy Court in order to enforce the rescission. The appellant then moved to dismiss and to compel arbitration on May 20, 2002.

The Bankruptcy Court denied American General's motion and did not enforce the arbitration provision. The Bankruptcy Court began its analysis by noting that the parties stipulated that the matter was a core proceeding and was within the court's discretion. It then determined that the matter would be best

resolved in the Bankruptcy Court because the outcome will affect the appellee's plan and its payment distribution to other creditors. The court also held that it would deny enforcement of the arbitration clause because there was a question raised about the neutrality of the arbitrator.

This case involves the interplay between the purposes of the Federal Arbitration Act ("FAA") and of the Bankruptcy Code. Congress created a strong presumption of arbitrability when it enacted the FAA. Section 2 of the FAA states that an arbitration clause shall be "valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract." 9 U.S.C. § 2. The FAA directs the courts to stay an action until arbitration has been completed if the arbitration agreement is valid. 9 U.S.C. § 3. The Third Circuit has recognized the "strong federal policy favoring arbitration" and "favoring enforcement of contractual obligations." Zimmerman v. Continental Airlines, 712 F.2d 55, 57 (3d Cir. 1983).

The bankruptcy courts have jurisdiction to decide bankruptcy matters. 28 U.S.C. §§ 1334, 157. This jurisdiction encompasses the power "to preserve the integrity of the reorganization process. United States Lines v. Am. S.S. Owners Mut. Prot. & Indem. Ass'n, Inc., 197 F.3d 631, 641 (2d Cir. 1999). The bankruptcy courts have broad discretion in carrying

out the purposes of the Bankruptcy Code. See id. at 640 (citing 11 U.S.C. § 105(a); 11 U.S.C. § 362(a)(1)). The question in this case is whether the bankruptcy court's power to decide bankruptcy issues overrides the FAA's preference for arbitration and, in turn, under what circumstances the bankruptcy judge may refuse to compel arbitration.

There are two Third Circuit cases that consider the enforcement of an arbitration clause in bankruptcy. In Zimmerman v. Continental Airlines, Continental Airlines, the appellant, had a contract with Ludwig Honold Manufacturing Company which included a liquidated damages provision and an arbitration clause. 712 F.2d at 56. Ludwig Honold later went into bankruptcy. The appellee, Fred Zimmerman, was appointed trustee and brought adversary proceedings in the bankruptcy court to invalidate the liquidated damages clause. The appellant moved for a stay pending arbitration. The Third Circuit affirmed the bankruptcy court's decision to deny a stay for arbitration. Id.

The opinion in Zimmerman stressed the congressionally recognized importance of arbitration and bankruptcy proceedings. The court then held that arbitration is generally not on the same level of importance as bankruptcy, because bankruptcy proceedings are essential "to the smooth functioning of the nation's commercial activities." Id. at 59. The Third Circuit ruled that the bankruptcy court must exercise its "sound discretion" in

deciding whether the enforcement of the arbitration clause would adversely impact the purposes of the Bankruptcy Code. Id. at 59-60.

The appellant bases much of its argument on Hays & Co. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 885 F.2d 1149 (3d Cir. 1989). The Hays opinion, like Zimmerman, balances the purposes of the FAA and of the Bankruptcy Code. In Hays, however, the Court of Appeals reversed the district court's decision to deny the enforcement of an arbitration clause in the non-core proceeding. Id. at 1150-51.

The Hays decision builds upon the holding of Zimmerman by ruling that the case did not present a conflict between the purposes of the Bankruptcy Code and of the FAA sufficient to deny arbitration in a non-core proceeding.¹ Id. at 1150. The opinion could not identify any provisions in bankruptcy applicable to the case which would substantially conflict with the purposes of the FAA. Id. at 1157-58. The holding thus clarified that bankruptcy courts usually must enforce arbitration clauses in non-core proceedings. Id. at 1156-57.

The appellant argues that Hays is dispositive here. The Court is not persuaded for two reasons. First, the proceeding in this case is core, as stipulated by both of the

¹ The Zimmerman decision does not discuss the distinctions between core and non-core proceedings.

parties. Tr. at 4. The Court interprets the holding of Hays, as do many other courts, as applying primarily to non-core proceedings. See United States Lines, Inc. v. Am. S.S. Owners Mut. Prot. & Indem. Ass'n, Inc., 197 F.3d 631, 640 (2d Cir. 1999); Pardo v. Pacificare of Tex., Inc. (In re APF Co.), 264 B.R. 344, 361-62 (Bankr. D. Del. 2001); Weinstock v. Frank (In re Weinstock), 1999 Bankr. LEXIS 616, at *23 (Bankr. E.D. Pa. 1999); Sacred Heart Hosp. v. Independence Blue Cross (In re Sacred Heart Hosp.), 181 B.R. 195, 202 (Bankr. E.D. Pa. 1995); In re FRG, 115 B.R. 72, 74 (E.D. Pa. 1990).

Second, the Hays court acknowledged that the bankruptcy courts have discretion to deny the enforcement of arbitration provisions even in non-core proceedings if there is a showing that the Bankruptcy Code, in text, legislative history, or purpose, conflicts with the enforcement of an arbitration clause. 885 F.2d at 1156.

The Third Circuit, therefore, has held in Zimmerman and Hays that the Bankruptcy Code gives bankruptcy courts discretion to refuse to compel the enforcement of arbitration agreements, but that discretion is severely limited when the proceeding is non-core. The question remaining for the Court is what are the criteria, in a core proceeding, for exercising that discretion.

To answer that question, the parties rely on two bankruptcy decisions from other Courts of Appeals that were

decided after Zimmerman and Hays. The decisions are helpful in that they provide a framework for analyzing when bankruptcy courts should retain jurisdiction and refuse to enforce arbitration agreements. They present two sets of circumstances when circuit courts have affirmed the bankruptcy courts' decision to deny a motion to compel arbitration.

The first case affirms the refusal to enforce arbitration when the dispute underlying the arbitration is based in rights created by the Bankruptcy Code. Ins. Co. of N. Am. v. NGC Settlement Trust & Asbestos Claims Mgmt. Corp. (In Matter of National Gypsum Co.), 118 F.3d 1056, 1061 (5th Cir. 1997). The Fifth Circuit denied arbitration of the issue of whether a confirmed reorganization plan bars post-confirmation collection efforts. Id. The case before this Court does not deal with substantive bankruptcy rights as Gypsum did.

The second case affirms a bankruptcy court's decision to deny enforcement of an arbitration clause, because the purposes of the Bankruptcy Code would have been adversely affected by the arbitration. United States Lines v. Am. S.S. Owners Mut. Prot. & Indem. Ass'n, Inc., 197 F.3d 631, 641 (2d Cir. 1999). The appellees were insurance companies seeking arbitration on the issue of insurance coverage for the appellant. The Second Circuit examined the situation functionally and determined that the resolution of the underlying issue would

determine whether reorganization was successful. The opinion stated that the "proceedings are integral to the bankruptcy court's ability to preserve and equitably distribute the Trust's assets." Id.

In coming to its conclusion, the court reviewed and relied upon the Hays decision. The Second Circuit held that although Hays applied to non-core proceedings, the decision was helpful in providing a standard for denying the enforcement of an arbitration clause. Id. at 640-41. The court in U.S. Lines held that a bankruptcy court may properly deny enforcement if the arbitration would have a significant adverse impact on the administration of the bankruptcy case. Id. at 641.

The Court will follow the U.S. Lines decision as fully consistent with Hays. The Court finds that the Bankruptcy Court acted within the appropriate bounds of its discretion. The court found that the arbitration provision, if enforced, could adversely affect several important purposes of the Bankruptcy Code. The court observed that purposes such as the preservation of the estate's assets, the protection of all creditors' interests, and the restructuring of the debtor-creditor relationship are at stake in situations like this case. The court ruled that the determination of whether the appellee's rescission is valid and whether the appellant's claim is secured

will directly impact the viability of the appellee's chapter 13 plan and the rights of other creditors.

The appellee currently pays \$275 per month to the appellant and \$10 per month to the trustee for the unsecured creditors, because she cannot afford to pay \$551 per month to the appellant as specified in the original mortgage refinancing loan. See Tr. at 23-24. If the rescission is valid, the appellee will owe much less money than the loan amount currently owed to the appellant. The remaining loan then would be unsecured. The appellee could pay \$285 per month, divided up among all of her creditors pro rata. See Tr. at 24-25.

The determination of the validity of the rescission would affect the rights of the other creditors. The determination also would impact the success of the plan and whether the appellee is able to keep her house. The Bankruptcy Court acted within the appropriate bounds of discretion in deciding that it is the best forum to resolve the matter.²

² The parties cite to other cases to support or contradict the holding of U.S. Lines. The appellee cites to In re Hemphill Bus Sales, Inc., 259 B.R. 865 (Bankr. E.D. Tex. 2001), which examined a similar series of events and came to the same holding as U.S. Lines. In Hemphill, the Bankruptcy Court concluded that arbitration was not appropriate because purposes of the Bankruptcy Code were at stake, including division of the estate and an "opportunity for a fresh start." Id. at 871.

Two cases were cited in which the arbitration clauses were enforced in core proceedings. The court in Weinstock v. Frank (In re Weinstock) found that the impact on the purposes of the Bankruptcy Code would not be great enough to deny

An appropriate Order follows.

arbitration. 1999 Bankr. LEXIS 616, at *29 (Bankr. E.D. Pa. 1999). The court dismissed as insufficient the debtor's argument that the dispute was core and complex. Id. at *29-32. The facts in Weinstock contrast with the facts of this case, because the parties in Weinstock were already in arbitration and there was a post-petition dispute.

The court in SFC New Holdings, Inc. v. Earthgrains Co. (In re GWI, Inc.) also enforced arbitration. 269 B.R. 114 (Bankr. D. Del. 2001). This case involved a confirmed plan, and it therefore did not sufficiently conflict with the policy favoring arbitration. Id. at 118. The facts of GWI are inapplicable to the case at hand.

IN THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF PENNSYLVANIA

IN THE MATTER OF:	:	CIVIL ACTION
ETHEL MARIE MINTZE,	:	
Appellee	:	
	:	
	:	
	:	NO. 03-2113

ORDER

AND NOW, this 12th day of November, 2003, upon consideration of American General Financial Services, Inc. and American General Consumer Discount Co.'s appeal of the Bankruptcy Court's Order in Bankruptcy No. 01-36979, IT IS HEREBY ORDERED that said Order is AFFIRMED, for the reasons discussed in a memorandum of today's date.

BY THE COURT:

MARY A. MCLAUGHLIN, J.